AGA
American Gas Association

March 30, 2015

<u>Via Electronic Submission</u>

Mr. Christopher Kirkpatrick
Secretary
Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Supplemental Comments of the American Gas Association, CFTC Position Limits for Derivatives, RIN No. 3038-AD99 (February 26, 2015)

Dear Mr. Kirkpatrick:

The American Gas Association ("AGA") appreciates the opportunity to comment on the Commodity Futures Trading Commission's ("CFTC" or "Commission") reopening of the comment period on its proposed rules on position limits for derivatives[1] (the "Proposal" or "Proposed Rules"), pursuant to a meeting of the CFTC Energy and Environmental Markets Advisory Committee ("EEMAC") on February 26, 2015. The AGA has been an active participant in the Commission's pending and prior position limit rulemakings promulgated under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). AGA is also an associate member of EEMAC and participated in the February 26 EEMAC meeting.[2]

AGA commends Commissioner Giancarlo's sponsorship of EEMAC and his successful convening of the first committee meeting. We thank the Chairman, and Commissioners Bowen and Wetjen, for taking the time to attend the meeting and participate in a discussion of how energy market participants use derivatives to hedge or mitigate commercial risk, and how this hedging activity should be viewed as the Commission crafts position limits rules. Pursuant to the issues raised at this meeting, AGA hereby submits these comments and urges the Commission to issue final rules that do not place undue burdens on energy market participants and protect gas utilities' bona fide hedging activity.

[1] *Position Limits for Derivatives*, 78 Fed. Reg. 75680 (Dec. 12, 2013).
[2] AGA Counsel, Regulatory Affairs, Arushi Sharma Frank, is an associate member of the EEMAC Advisory Committee and participated in the February 26, 2015 meeting.

I. Communications

All correspondence in regard to this proceeding should be delivered to the following:

Arushi Sharma Frank
Counsel, Regulatory Affairs
American Gas Association
400 N. Capitol St., NW
Washington, DC 20001
asharma@aga.org | 202.824.7120

II. Identity and Interests

The American Gas Association, founded in 1918, represents more than 200 local energy companies that deliver clean natural gas throughout the United States. There are more than 71 million residential, commercial and industrial natural gas customers in the U.S., of which 92 percent — more than 65 million customers — receive their gas from AGA members. AGA is an advocate for natural gas utility companies and their customers and provides a broad range of programs and services for member natural gas pipelines, marketers, gatherers, international natural gas companies and industry associates. Today, natural gas meets almost one-fourth of the United States' energy needs. For more information, please visit www.aga.org.

AGA's members engage in financial risk management transactions in markets regulated by the Commission. AGA member companies provide natural gas service to retail customers under rates, terms and conditions that are regulated at the local level by a state commission or other regulatory authority with jurisdiction. Many gas utilities use a variety of financial tools, such as futures contracts traded on Commission-regulated exchanges and over-the-counter energy derivatives, to hedge the commercial risks associated with providing safe, reliable and cost-effective natural gas service to its customers. As such, AGA's members will be directly affected by the Commission's regulations governing position limits for futures and swaps.

III. Comment Summary

AGA respectfully submits that position limits rules must "ensure *sufficient market liquidity* for bona fide hedgers" and provide for exemptions to position limits for bona fide hedging transactions or positions defined "to permit producers, purchasers, sellers, middlemen, and users of a commodity or a product derived therefrom to *hedge their legitimate anticipated business needs* for that period of time into the future for which an appropriate futures contract is open and available on an exchange."[3] At the February 26, 2015 EEMAC meeting, Commissioner Giancarlo echoed these statutory edicts, noting that:

> Congress recognized this concern [that liquidity is the vital component of healthy and vibrant derivative markets] in instructing the Commission to set position limits in a way that maintains liquidity for hedgers. The Commission should heed the prescription of Dodd-Frank and carefully analyze the effects of its rules on available liquidity.

[3] *See* CEA § 4a(c)(1)-(2), 7 USC § 6a(c)(1)-(2) (emphasis added).

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> I and others have expressed concern that the proposed bona fide hedging rules not be structured in a way that imposes federal regulatory edicts in place of business judgment in every day commercial risk management. This afternoon's panel should give us a better understanding of the likely impact of the proposed rules on U.S. energy markets and whether those concerns are apt.[4]

AGA agrees that final rules on the Proposal ("Final Rules") should allow for reasonable commercial hedging activities and should ensure that there is adequate liquidity by establishing appropriate limit levels. Accordingly, AGA provides the following comments:

- AGA reaffirms its pending February 10, 2014 comments in RIN 3038-AD99.
- The Final Rules should include an enumerated hedge for anticipatory merchandising activities.
- The Final Rules should (i) clarify that the definition of "bona fide hedging position" includes, but is not limited to, enumerated hedges and includes non-enumerated hedges and (ii) include a fast and efficient process for approving non-enumerated hedges (AGA recommends this be done at the exchange).
- The Final Rules should categorically exclude Trade Options from position limits because Trade Options, by definition, are physical delivery instruments designed to provide delivery of the underlying physical commodity and are in no way similar to positions that financially hedge the risks of physical assets.
- The Final Rules should provide for a single hedge exemption application and reporting process and should not require applicants to file duplicative forms at the exchange and at the Commission. Toward that goal, AGA supports Final Rules that delegate, to the exchanges, (i) the hedge exemption application and approval process, and (ii) hedge exemption reporting, if any is required.

IV. Comments

(1) The Final Rules should include the anticipated merchandising hedge.

AGA supports adding the Anticipatory Merchandising Hedge ("AMH") to the list of enumerated hedges. AGA agrees with other EEMAC members, such as the Commercial Energy Working Group, that the Commission should add the following to the definition of "*Bona fide* hedging position" in Proposed Rule §150.1:

> (vii) ***Hedges of Storage and Transportation***. Offsetting long and short positions in commodity derivative contracts representing the differential in either timing or location with respect to storage or transportation of the commodity underlying the commodity derivative contracts.

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[4] *See* February 26, 2015 EEMAC meeting transcript ("Transcript"), available at http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/emactranscript022615.pdf, at 8-9.

(viii) ***Hedges of Assets Owned or Anticipated to be Owned***. Positions in commodity derivative contracts that hedge the value of an asset used to produce, process, store or transport the commodity underlying the derivative.[5]

At a minimum, although AGA supports an AMH for any qualifying hedgers of storage or transportation assets, the AMH should be included, in the Final Rules, for *natural gas* storage and transportation assets (and any other anticipated merchandising of natural gas) for the myriad reasons put forth in the comments, roundtables, and public meetings that constitute a voluminous docket on this issue before the Commission.

The inclusion of the AMH in the Final Rules is necessary to protect and preserve natural gas utilities' and their counterparties' ability to freely transact in ordinary commercial hedging activities tied to gas storage assets. Without an enumerated AMH, parties would either (a) be precluded from entering into gas storage hedges and similar hedges of gas assets that rely on the AMH ("Preclusion Issue"), and/or (b) be forced to petition the Commission, even after the Final Rules, to amend the Final Rules to include the AMH or otherwise approve of the AMH before they enter into such a hedge ("Petition Issue"). As explained below, both the preclusion of such activity, or a piecemeal petition process to permit it, would reduce liquidity and severely constrain, raise costs for, and create undue risk for gas utilities -- without any benefit to the Commission's interest in reducing excessive speculative activity.

With respect to the Preclusion Issue, as the Commission's 2011 proposal correctly observed,[6] the AMH of storage and transportation assets is a well-established, well-understood, and non-controversial risk mitigating hedge widely used in the gas industry – a "bread and butter," "plain vanilla" hedge as made clear at the February 27, 2015 EEMAC meeting.[7] Indeed, this hedge, particularly in the natural gas industry, has been described in detail and consistently supported by market participants in numerous pending comments on this rulemaking.[8] Simply put, this hedge unquestionably mitigates commercial risk of anticipated merchandising transactions related to gas storage and transportation assets, among other commodities and assets, and is exactly the type of risk mitigation technique that Congress sought to preserve by carving out bona fide hedge exemptions from position limits.[9]

AGA agrees with prior comments that the AMH is appropriate to mitigating risk of a commercial enterprise, because, even before physical gas contracts are secured, NYMEX Henry

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[5] February 10, 2014 Comments of CEWG (RIN 3038-AD99) (submitted by R. Michael Sweeney) at 25-26.

[6] The vacated prior rules specifically included the AMH in the list of enumerated hedge transactions, and even included a "fact pattern" explaining why a grain merchandiser's hedge of a storage facility appropriately hedges the merchandiser's "risk that its unfilled storage capacity will not be utilized over th[e] period" of its hedge. *Position Limits for Futures and Swaps; Final Rule and Interim Final Rule*, 76 Fed. Reg. 71,626, at 71,698 (Nov. 18, 2011) ("vacated final rules"). The vacated final rules concluded that a hedge that is a substitute for a fixed-price forward purchase and an equivalent volume of fixed price forward sale meets the general hedge definition of section 4a(c)(2) of the Commodity Exchange Act ("CEA"). Thus, the vacated final rules correctly identified the associated price risks and correctly found that a merchandiser's calendar spread hedge met the general hedge definition. The vacated final rules got it right. The Commission should grant the same hedge in the Final Rules.

[7] Transcript at 176 (Sharma Frank); 178 (Oppenheimer);

[8] See bullet list of pending comments in this rulemaking, set forth in the next paragraph.

[9] *See* CEA § 4a(c)(1), 7 U.SriadC. § 6a(c)(1) (hedge exemption to position limits must allow hedgers "to hedge their legitimate *anticipated* business needs for that period of time into the future for which an appropriate futures contract is open and available on an exchange") (emphasis added).

Hub and related futures contracts can be and are in fact used to lock-in the price differential between gas injection months and gas withdrawal months (for the storage hedge), or to lock-in the price differential between gas trading points for the same month or day (for the transportation hedge). An anticipated hedge – the AMH – is thus needed for this common, routine, and risk reducing hedge. Furthermore, the AMH qualifies as a bona fide hedge under the statutory (general) hedge definition, as illustrated in the storage hedge example presented at the February 26, 2015 EEMAC meeting:

> The winter storage transaction should be given BFH treatment because:
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> A. It was a substitute for transactions to be made at a later time in a physical marketing channel (i.e. the purchase of natural gas to fill storage and withdraw from storage);
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> B. It was economically appropriate to the reduction of Supplier's risk (i.e. that it will be able to recover the cost of its storage obligation and profit from its business of supplying natural gas in the winter); and
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> C. It arose from the potential change in value of an asset (natural gas/storage) that Supplier owned (storage) and anticipated owning (natural gas).[10]

For efficiency, AGA will not repeat the arguments for, or the mechanics of, the AMH in the natural gas industry, which have been articulated in detail in pending comments on this rulemaking, which, AGA notes, have not been opposed by any other commenters. Accordingly, in support of including the AMH, AGA refers the Commission to the following comments and other support for the AMH and asks the Commission, on the basis of the wealth of comments on this topic, to include the AMH as an enumerated hedge in the Final Rules:

- February 10, 2014 Comments of CEWG) (RIN 3038-AD99) (submitted by R. Michael Sweeney) at 16-20 and 23-26.
- February 10, 2014 Comments of CME Group (RIN 3038-AD99) (submitted by Kathleen Cronin), at 56-59.
- February 10, 2014 Comments of Natural Gas Supply Association (RIN 3038-AD99 and 3038-AD82) (submitted by Ryan Berry), at 19-25.
- June 26, 2014 Comments of Natural Gas Supply Association (RIN 3038-AD99 and 3038-AD82) (submitted by Ryan Berry), at 9-10.
- August 4, 2014 Comments of CEWG (RIN 3038-AD99) (submitted by Meghan Gruebner), at 2-3 and 5-6.
- February 26, 2015, "Illustrative Hedging Examples" presentation by Ronald S. Oppenheimer at the EEMAC meeting
- Comments by Ronald S. Oppenheimer at the EEMAC meeting, February 26, 2015, at Transcript 156-182.

[10] February 26, 2015, "Illustrative Hedging Examples" presentation by Ronald S. Oppenheimer on behalf of Commercial Energy Working Group ("CEWG"), presented at Energy and Environmental Markets Advisory Committee Meeting, February 26, 2015, available at http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/eemac022615_oppenheimer.pdf.

With respect to the Petition Issue, declining to include the AMH in the Final Rules would simply delay ruling on allowing the hedge because, if the hedge is denied in the Final Rules, parties seeking to use the hedge would be forced to seek a hedge exemption by petition or another process. This delay is unnecessary because there is sufficient evidence and support for the AMH *at this time*. Legitimate hedgers need to use the AMH now and in the future, and for that reason alone the AMH must be included in the Final Rules.

During the EEMAC meeting, Mr. Steven Sherrod, Senior Economist, CFTC's Division of Market Oversight, was asked why the AMH was not included in the Proposed Rules as an enumerated hedge. Mr. Sherrod responded by indicating that the Commission was essentially seeking more comment on the AMH, *i.e.*, that the Commission was asking, in its Proposed Rules, "a series of questions about what would make this a bona fide transaction. What could be shown further?"[11] Mr. Sherrod voiced his concern that in some cases, a corn storage bin could claim a hedge for corn, wheat, or soybeans, although the corn bin never traded those products.[12]

AGA contends that any concern about a hedger's specific "fact pattern,"[13] its history of merchandising, or its ownership or planned ownership of assets is not a reason to deny the *availability* of the AMH for all legitimate hedgers. First, gas storage assets can only be used to store pipeline quality natural gas consistent with the storage operator's approved tariff, and so there is no reason to deny the availability of the hedge for the natural gas market simply because some non-gas facilities could be used for different products.[14] Second, the potential for misuse of a hedge is a separate issue entirely from the *availability* of the AMH in the first place – and the concern over potential misuse should not cause the Commission to deny legitimate risk mitigation techniques by excluding the AMH in the Final Rules. By contrast, workable rules permitting legitimate hedging activity should make it easier for the Commission to identify abnormal or suspect market activity. Ensuring that a hedge applicant relying on the AMH legitimately has, or anticipates having, the assets required for the exemption is simply a matter of policing the proper use of the hedge application. This can be done when the applicant seeks and maintains the hedge. Such a process – ensuring the authenticity of an exemption request for the AMH – is no different than ensuring the authenticity of an exemption request for a hedge of fixed-price transactions or anticipated services (both of which are allowed under the Proposed Rules), namely that the applicant in fact has fixed-price contracts in place or properly anticipates the services contracts. As explained at the EEMAC meeting, the exchanges routinely perform this type of enforcing *now*.[15] In fact, parties seeking a hedge exemption for exchange position limits must justify the hedge with an application discussing the data, contracts, or assets giving rise to the hedge exemption, and all hedges are subject to review if misused.[16]

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[11] Transcript at 175 (Sherrod).
[12] *Id*. at 174-75.
[13] *See* Transcript at 168-170 (Wetjen, Sherrod, Oppenheimer) (discussing Staff's proposed denial of a floating (non-fixed) price hedge because a given "fact pattern" might not qualify as a bona fide hedge). For the same reasons that the AMH should be available for those who have legitimate hedging needs, the floating (non-fixed) price hedge should be included as an enumerated hedge in the Final Rule.
[14] Transcript at 178 (Oppenheimer).
[15] *Id*. at 102, 114; *see also id*. at 180 (CME reviews "past practice and the business" of hedge applicants).
[16] *See, e.g.*, CME Rule 559 ("A person seeking an exemption from position limits must apply to the Market Regulation Department on forms provided by the Exchange" and must, *inter alia*: "Provide a complete and accurate explanation of the underlying exposure related to the exemption request;" "Agree to promptly provide, upon request

The Commission has enough information to rule on the AMH now and should not delay adding it to the list of enumerated hedges. Bona fide hedge exemptions should preserve commercial entities' ability to transact in liquid markets for contracts that support their legitimate business needs. Undue constraints on, or a cumbersome petition/exemption process for anticipatory hedging, would be detrimental to the natural gas marketplace, with cascading impacts on liquidity and hedging costs that would raise prices for American energy consumers.

(2) The Final Rules should (i) clarify that the definition of "bona fide hedging position" includes non-enumerated hedges and (ii) include a fast and efficient process for approving non-enumerated hedges

For the reasons discussed below, AGA urges the Commission to revise the definition of "Bona fide hedging position" in proposed rule 150.1 as follows:

- Revise the definition of "bona fide hedging position" to state that the definition "includes, but is not limited to" the enumerated hedges listed in paragraph (3), (4) or (5) of the definition; and
- Include, in the definition of "bona fide hedging position", a process for obtaining approval of non-enumerated cases that is time limited and workable (akin to Regulation 1.47); or
- In the alternative, and at a minimum, clarify in the definition of "bona fide hedging position" that a hedge that does not satisfy one of the enumerated hedge definitions may be recognized as a hedge upon application to the Commission under a Regulation 1.47-like process.

The Proposed Rules defining "bona fide hedging position" and the existing rules defining "bona fide hedge," Regulation 1.3(z) and Regulation 1.47, differ in a material respect. In the Proposed Rules, a bona fide hedge must meet *both* the general hedge definition *and* satisfy one of the enumerated hedges (with no proposed process for seeking a non-enumerated hedge short of a petition to the Commission),[17] while under the existing rules, a hedge may qualify as a bona fide hedge by meeting the conditions of the general definition in Regulation 1.3(z)(1), and may, but is not required to, satisfy such general definition by fitting within one of the enumerated hedges in regulation 1.3(z)(2): "The definitions of bona fide hedging transactions and positions in paragraph (z)(1) of this section *includes, but is not limited to*, the following specific transactions and positions."[18]

There is an important reason for the structure of the existing rules as compared to the Proposed Rules. Namely, it is the general definition of bona fide hedge that governs, and satisfying

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by the Market Regulation Department, information or documentation regarding the person's financial condition; and "Agree to promptly submit a supplemental statement to the Market Regulation Department whenever there is a material change to the information provided in the most recent application."); ICE Futures U.S. Rule 6.29 ("To be eligible for an exemption under this Rule, a Person seeking the exemption must submit to the Exchange a written request, in the form provided by the Exchange, which shall include the following," *inter alia*: "a description of the size and nature of the proposed positions;" "a statement that the Person seeking the exemption agrees to submit immediately a supplemental statement to the Exchange explaining any change in circumstances affecting the positions;" and "such further information as the Exchange may request.")

[17] As proposed, Rule 150.1 requires a hedge to meet the general definition (section (2)(i) of the definition), "and" be enumerated (section (2)(i)(D) of the definition, referencing sections (3), (4), or (5) of the definition).

[18] 17 C.F.R. §1.3(z)(2) (emphasis added).

an enumerated hedge is one way to satisfy the general hedge definition. Toward that end, the existing rules also include a 30-day process (Regulation 1.47) for obtaining approval of a non-enumerated hedge.[19] As the Commission stated in the 1977 rulemaking[20] leading to the 1977 rules:

> Paragraph (2) of the proposed definition enumerates specific transactions and positions which the Commission views as conforming to the general definition of bona fide hedging in paragraph (1) *without further consideration as to the particulars of the case*.[21]

In contrast, the purpose of including Regulation 1.3(z)(3) ("*Non-enumerated cases*") in the 1.3(z) hedge definition was as follows:

> Paragraph (3) of the Proposed definition of bona fide hedging provides that for purposes of determining exemptions from limits on transactions and positions fixed pursuant to section 4a of the Act the Commission may recognize as bona fide hedging purchases and sales other than those specifically enumerated in proposed paragraph (2). Proposed paragraph (3) requires that any person requesting permission to classify such purchases or sales as hedging provide the Commission with evidence that such transactions meet the requirements of the general definition in paragraph (1) of proposed § 1.3(z) and will be consistent with the general objectives of the Act. *The purpose of this paragraph is to provide flexibility in application of the general definition and to avoid an extensive specialized listing of enumerated bona fide hedging transactions and positions in paragraph (2) of the proposed definition*.[22]

At no time (until now) has the Commission ever attempted to constrict bona fide hedge transactions to only the enumerated hedges in Regulation 1.3(z)(2) (short of a petition to the Commission). There is good reason for this. In its final order adopting the 1977 rules, the Commission stated that the "intended effect" of its 1977 bona fide hedge definition, including the Regulation 1.3(z)/1.47 process, was as follows:

> The intended effect of this action is to increase commercial utilization of futures markets for the purpose of hedging by allowing additional exemptions from the Commission's limits on transactions and positions. *It is also intended to encourage increased commercial participation through recognition of a broad range of current risk shifting uses of futures markets*.[23]

Now that the Commission is proposing to expand the scope of position limits beyond the legacy nine agricultural contracts, the flexibility of the current Regulation 1.3(z)/1.47 process is needed more than ever – even with an expanded list of enumerated hedges. As noted by AGA at the EEMAC meeting, it is not possible for any one public commenter to fully capture up-front the panoply of non-enumerated hedges that are deserving of bona fide hedge treatment by the

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[19] Regulation 1.47, in turn, specifically cites Regulation 1.3(z)(1), *the general definition*, as the basis for granting a non-enumerated bona fide hedge. 17 C.F.R. § 1.47(b)(3).
[20] *Bona Fide Hedging Transactions or Positions*, 42 Fed. Reg. 14,832 (Mar. 16, 1977).
[21] *Id*. at 14,832 (emphasis added).
[22] *Id*. at 14,833 (emphasis added).
[23] *Definition of Bona Fide Hedging and Related Reporting Requirements*, 78 Fed. Reg. 42,748 at 42,748 (Aug. 24, 1977) (emphasis added).

Commission. An expanded list of hedges is useful because the types of products and asset classes covered by federal position limits have been expanded, and therefore the types of hedges that qualify under the general definition as enumerated hedges likewise should be expanded.[24] But even with an expanded list of enumerated hedges, the Commission cannot contemplate every reasonable bona fide hedge used to legitimately hedge commercial risk, as the EEMAC meeting and other meetings and comments have shown.

Accordingly, the Commission should clarify that the general definition defines what is a "bona fide hedge," and that those hedges include, *but are not limited to*, the enumerated hedges. Indeed, such an approach is consistent with the current Commission rules and consistent with how the exchanges currently administer exchange-set position limits, and that process has proven to be workable to enforce position limits and hedge exemptions over a large set of products and asset classes. As noted below, AGA recommends a single hedge application process, administered by the exchanges.

Furthermore, the Commission should ensure that there is a meaningful process to request a non-enumerated hedge and obtain approval in a time-limited manner upon a showing that the applicant meets the general bona fide hedge definition. Unlike the current Regulation 1.3(z)(3) and 1.47 process, the Proposal does not provide a meaningful, time-limited application process. Rather, proposed rule 150.3(e)(2) allows parties seeking an exemption for a non-enumerated BFH to request "[e]xemptive relief under section 4a(a)(7) of the Act" (which relates to general exemptions from position limits). It is unclear whether the Commission would grant such relief through notice and comment procedures or not. In either case, the delays caused by a petition process would effectively foreclose risk-mitigating hedges that do not fall under one of the enumerated hedges, rendering the petition process unworkable.[25] Because the Proposal seeks to expand federal speculative position limits to numerous new markets and products, AGA recommends that the Commission clearly restate, and in fact improve, the Regulation 1.47-like 30-day review process by providing for (i) an expedited review or provisional approval in cases of immediate, spot-month hedging needs and (ii) a right of reconsideration

Finally, AGA notes that the Proposed Rules would narrow the statutory definition and therefore make it more difficult for hedgers to use derivatives to hedge commercial risk, in direct opposition to the statutory requirements and goals. Congress defined bona fide hedging transactions or positions in CEA section 4a(c)(2). That definition is largely the same as the general definition in current Regulation 1.3(z)(1),[26] and, significantly, does not further limit acceptable

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[24] In its 1977 final rule, the Commission agreed with commenters that noted that the enumerated transactions listed in 1.3(z)(2) would be "deficient for certain commodities where the Commission currently has no speculative limits." 42 Fed. Reg. at 42,750.

[25] For example, if a non-enumerated hedging opportunity arises and the Commission does not act within 30 days or less, the hedging party would be forced to liquidate spot month positions prior to the spot month (e.g., the last three trading days of the Henry Hub gas futures contract) if it otherwise would exceed the speculative limits. This liquidation could destroy the value of the hedge: that is, if the hedge were linked to the prompt month settlement price, liquidating before the settlement period would expose the hedger to price movements during the last three trading days.

[26] Note that the statutory definition of a "bona fide hedge" in CEA section 4a(c)(2) is largely the same as the Commission's historic "general definition of bona fide hedging" adopted in the 1977 rulemakings and codified in 17 C.F.R. 1.3(z)(1). The main difference is the Temporary Substitute criterion (the stricken word indicating a term dropped in CEA section 4a(c)(2): the BFH "~~normally~~ represents a substitute for transactions made or to be made or

hedges to a list of enumerated hedges. Specifically, in CEA section 4a(c)(2), Congress provided that: "For the purposes of implementation of subsection (a)(2) [for futures contracts], the Commission *shall* define what constitutes a bona fide hedging transaction or position *as a transaction or position that…*" meets the elements of the general hedge definition, which the statute then proceeds to set forth.

Congress did not provide the Commission discretion to invent a new definition of bona fide hedge or otherwise restrict the statutory bona fide hedge definition in ways that conflict with the statute. In fact, under CEA 4a(c)(1), any Commission further definition must be "consistent with the purposes of this chapter" and must be defined "to permit producers, purchasers, sellers, middlemen, and users of a commodity or a product derived therefrom to hedge their legitimate *anticipated* business needs for that period of time into the future for which an appropriate futures contract is open and available on an exchange."[27]

By denying the AMH to legitimate hedgers, and by restricting bona fide hedges to a list of enumerated hedges without a timely and meaningful non-enumerated application process, the Proposed Rules defining bona fide hedge conflict with the statute. Accordingly, AGA recommends that the Commission revise the Proposed Rules as outlined above.

(3) The Final Rules should categorically exclude Trade Options from position limits

The Proposed Rules would subject physical commodity trade options that satisfy the Commission's trade option rules[28] to speculative position limits. However, the Commission also sought comments on whether it should exclude trade options from the definition of referenced contracts and, thus, to exempt trade options from the proposed position limits.[29] In its February 10, 2014 comments, AGA urged the Commission to amend its proposal to exclude trade options from the definition of a "referenced contract" and set forth reasons why the Commission should not subject trade options to speculative limits. AGA renews its pending comments on this point, and desires to explain in additional detail why subjecting natural gas trade options to speculative position limits makes no sense and misconstrues the nature of what trade options are in the natural gas industry.

First, because those trade options that would be subject to positon limits are only those trade options that are deemed to be "referenced contracts" as defined in proposed rule 150.1, trade options that are subject to position limits must either be those trade options that are (1) "directly or indirectly linked" to the price of a core futures contract or (2) "directly or indirectly linked" to the "price of the same commodity underlying that particular core referenced futures contract for delivery at the same location." Since the Proposal identifies the NYMEX Henry Hub NG contract as a core contract, only those natural gas trade options that are (1) priced on or linked to the NG contract, or, arguably, (2) priced based on monthly or daily index prices for natural gas delivered to Henry Hub, would be subject to position limits. On the other hand, trade options that are priced

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positions taken or to be taken at a later time in a physical marketing channel." That change, however, does not modify the scope of bona fide hedges available to commercial market participants using derivatives to hedge.

[27] *See* CEA § 4a(c)(1), 7 USC § 6a(c)(1) (emphasis added).

[28] *Commodity Options, Final rule and interim final rule*, 77 Fed. Reg. 25,320 (April 27, 2012) ("Trade Option Final Rule").

[29] Proposed Rules at 75,711.

at a fixed price or priced based on one of the hundreds of other index prices throughout North America would not be subject to position limits because such contracts would not meet the definition of referenced contracts.

This result is illogical. Natural gas is competitively traded throughout North America at any number of trading points. Market participants may seek to use as the pricing component the local index price, a fixed price (which typically is rare except for prompt month baseload gas or next day gas), or, because it is a liquid point, the NYMEX Henry Hub futures price. If trade options are included in position limits, the Commission's position limit rules would have a chilling effect on using the NYMEX Henry Hub price in trade options, and, potentially, have a chilling effect on transacting any trade options at Henry Hub. This would create an artificial incentive to use other, potentially less liquid, trading points as the purchase price in trade options or force parties to simply transact forward contracts. AGA can think of no apparent reason to disproportionately curtail NYMEX Henry Hub-priced trade options over all other contract prices or types, and nothing in the Proposed Rules explains the rationale for such a proposal.

Second, subjecting natural gas trade options to position limit rules misconstrues the fundamental nature and characteristics of these contracts, particularly as they are used in the natural gas industry. There is no reason to include trade options in position limits any more than forward contracts. Trade options are physical delivery instruments, not hedging instruments or any type of derivative for which speculative position limits are appropriate. The Commission recognizes this in its Trade Option rules, as trade options must be "intended to be physically settled so that, if exercised, the option would result in the sale of an exempt or agricultural commodity for immediate or deferred shipment or delivery."[30] In other words, a trade option, in Commission nomenclature, if "struck," results in a physical forward or a spot sale, and forwards and spot sales are not subject to position limits. Also, a Henry Hub-index based trade option (the only type of trade option that would be subject to position limits as meeting the "referenced contract" definition) is a floating price physical contract and has the same "risk" as an index-priced forward contract, *i.e.*, physical delivery risk and index price risk, but not outright price risk. A trade option does not need to be "netted" against derivatives for position limit purposes any more than a forward contract. [31] Thus, trade options are in no way substitutes for, or equivalent to, purely financial transactions or derivatives and do not pose financial market risks. In contrast, *financially-settled futures*, or even physical delivery futures which are almost always liquidated prior to delivery, are *financial hedging instruments*.

Third, limits on natural gas trade options would have penalizing effects on natural gas end-users and their non-SD/MSP counterparties, limiting the amount of *physical natural gas* these market participants could purchase under such a contract structure (where the contract is priced based on Henry Hub index prices), regardless of their physical gas needs. Limitations on physical market transactions would further limit the number of derivatives (based off of Henry Hub index prices) that the end-user could enter into. By example, if a natural gas utility held a trade option for 10,000 dekatherms of natural gas at the first-of-the-month Henry Hub Natural Gas price for the month of April, then the utility would have to hold one less Henry Hub call option contract for

[30] 17 C.F.R. § 32.3(a)(3).

[31] The Proposal asks commenters to consider that if "trade options were excluded from the definition of reference contracts, then commodity derivative contracts that offset the risk of trade options would not automatically be netted with such trade options for purposes of non-spot month position limits." Proposed Rules at 75,711.

April. Such a requirement, that would compel a natural gas end-user to modify its physical natural gas portfolio to comply with position limits for financial activity, is a costly and illogical result that is far beyond the Commission's regulatory mandate to control speculation. Nothing in CEA section 4a or in the Dodd-Frank Act in general indicates that Congress intended to limit physical trading activity by commercial market participants, and the Commission should not do so by subjecting trade options to speculative position limits.

For these reasons, subjecting trade options to position limits does not improve the Commission's ability to monitor the financial markets for excessive speculation. On the other hand, doing so could seriously distort physical markets and constrain the resources and tools available to gas utilities for meeting their customers' needs. Ultimately, including trade options toward position limits would burden energy consumers by increasing the commodity procurement costs utilities must pass through to ensure reliable and affordable supply of natural gas, particularly during critical demand periods like the annual winter heating season.

Therefore, AGA opposes the inclusion of trade options in speculative position limits.[32] AGA urges the Commission to categorically exclude trade options from the speculative position limits final rule, and also to provide this exclusion in any further action taken on the interim final commodity trade option exemption rule. AGA is concerned that if there are further comment periods or other delays in the finalization of the position limits rules, the issue of trade options will remain unresolved – even though it is a simple fix that can be quickly addressed, unlike many other position limits issues. Additionally, the trade option rule is the correct place for the regulator to develop all rules pertaining to the treatment of trade options. Any Commission effort to streamline the interim final trade option rule with other guidance on Form TO would fall short if all key issues, including position limits, were not addressed in the same rulemaking.

(4) The Final Rules should provide for a single hedge exemption application and reporting process and should not require applicants to file duplicative forms at the exchange and at the Commission.

AGA supports Final Rules that delegate, to the exchanges: (i) the hedge exemption application and approval process, and (ii) hedge exemption reporting, if any is required. AGA also urges the Commission to ensure that hedge exemption requests and any hedge reporting do not require duplicative filings at both the exchanges and the Commission, and therefore recommends revising the rules to streamline the process by providing that an applicant need only apply to and report to the exchanges, while the Commission could receive any necessary data and applications by coordinating data flow between the exchanges and the Commission.

At the February 26, 2015 EEMAC meeting, CME and ICE representatives explained in detail how they administer position limits and bona fide hedge applications with respect to their contracts, including the four core energy contracts in the Proposed Rules.[33] As ICE noted, market participants seeking hedge exemptions must "justify the exposure and the level, and in the end, the Exchange makes the determination on whether the exemption, even if it can fully be supported, is appropriate for the market."[34] As CME noted, they have position limits in the spot month for all

[32] *See, e.g.*, February 10, 2014 Comments of CEWG at 55-58; February 10, 2014 Comments of Natural Gas Supply Association at 27-37; June 26, 2014 Comments of Natural Gas Supply Association at 11-14.
[33] Transcript at 95-104 (Haas); 104-118 (Lasala).
[34] *Id*. at 102.

of their contracts and had them "for a long time."[35] Moreover, when CME grants hedge exemptions, those exemptions are not open-ended; rather CME considers the product and the applicant's business, and sets an appropriate hedge level.[36]

The clear import of ICE's and CME's administration of position limits is that the exchanges, rather than the Commission, have a long history with enforcing position limits on all of their contracts and are in a much better position than the Commission to judge the applicant's hedging needs and set an appropriate hedge level for the hedge being sought. Exchanges, rather than the Commission, should be the interface for market participants seeking hedge exemptions. To be consistent with our recommendations above, exchanges must be able to rely on the general definition of bona fide hedge as the basis for granting hedges of exchange limits, including those that may have a federal set level. The Commission should clarify, therefore, that the enumerated hedges are non-exclusive means of showing a bona fide hedge need. Finally, avoiding duplicative processing of hedge applications and reports would lessen the regulatory burden on hedgers – the very class of derivatives market participants that Congress sought to protect in the CEA.

V. Conclusion

AGA members are concerned that the position limit rules have become a means for increasing burdens on hedgers, despite the fact that the stated goal of the statute is to curb "excessive speculation" leading to unreasonable fluctuations or unwarranted changes in commodity prices. The Commission could lessen burdens on gas utilities and other bona fide hedgers by adopting the recommendations in these comments, without any impacts to the Commission's interest in curbing excessive speculation. AGA appreciates this opportunity to comment and thanks the Commission for hosting an EEMAC meeting to review these issues.

Sincerely,

American Gas Association

CC: Chairman Timothy Massad
Commissioner Sharon Bowen
Commissioner J. Christopher Giancarlo
Commissioner Mark Wetjen
Mr. Ajay Sutaria, Secretary, Energy & Environmental Markets Advisory Committee

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[35] *Id*. at 112.
[36] *Id*. at 114; *see also id*. at 180 (CME reviews "past practice and the business" of hedge applicants).